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THE STATUTORY CLOSE CORPORATION: A CRITIQUE AND A CORPORATE PLANNING ALTERNATIVE

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INTRODUCTION

Statutes that accord special recognition to close corporations¹ are chiefly characterized by requirements respecting unanimity of stockholder action,² restrictions upon the transferability of stock,³ potential elimination of a board of directors,⁴ relaxation of formal-

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1. Maryland's special statutory treatment for the close corporation is provided for in MD. CORP. & ASS'NS CODE ANN. §§ 4-101 to 4-603 (1975) [hereinafter cited as CODE]. This article will sometimes refer to such statute as the "Maryland Act" or "Title Four." At last count, five other states had provided for special statutory treatment of the close corporation. These states are Delaware (DEL. CODE ANN. tit. 8, §§ 341-56 (1967)), Kansas (KAN. STAT. ANN., §§ 17-7201 to -7216 (1973)), Pennsylvania (PA. STAT. ANN. tit. 15, §§ 1371-86 (1968)), Rhode Island (R.I. GEN. LAWS ANN., §§ 7-1.1-.51 (1969)), and Texas (TEX. BUS. CORP. ACT ANN. art. 2.30-1 to .30-5 (1973)). Significantly, Florida, effective January 1, 1976, has repealed its close corporation statute. This article will refer generally to corporations organized under such legislative provisions as "statutory close corporations," and to those under Maryland's Title Four, as "Title Four Corporations."

2. CODE § 4-201(b)(2)(ii) (requiring affirmative vote of every stockholder for election to be a Title Four Corporation); *id.* § 4-203 (affirmative vote of every stockholder needed to remove statement of election to be a Title Four Corporation); *id.* § 4-401(b) (providing for unanimous written consent to amend a stockholders' agreement); *id.* § 4-501 (issuance or sale of stock must be approved by all of the stockholders, unless otherwise permitted by stockholders' agreement); *id.* § 4-601 (every stockholder must approve a consolidation, merger, or transfer of assets of a Title Four Corporation). Affecting all of these unanimity requirements is section 4-504(b) which provides that "[n]otwithstanding the provisions of § 2-104(b)(5) of this article, the charter of a close corporation may not lower the proportion of votes required to approve any action for which this title requires the affirmative vote or assent of every stockholder or every subscriber for stock of the corporation."

3. *Id.* § 4-503.

4. *Id.* § 4-302.

ties,⁵ and special dissolution provisions.⁶ Foremost among the claimed benefits of close corporation statutes is their authorization of unanimous stockholders' agreements which may regulate the affairs of the corporation and its stockholders.⁷

Respected legal authorities have described such statutes as affording novel benefits and flexibility in planning a corporate enterprise with a limited number of stockholders.⁸ These advocates invariably refer to the ease and simplicity of organizing privately-held corporate entities under the close corporation statutes.⁹ The Maryland Act has been described as representing "one of the most significant steps toward special recognition and treatment of the close corporation yet taken by any state."¹⁰ As a result of such encomiums, numerous statutory close corporations have been organized in Maryland since the adoption of the Maryland Act in 1967.¹¹

5. *Id.* § 4-402 (stockholders' annual meetings need not be held unless requested by a stockholder).

6. *Id.* §§ 4-602 & 4-603.

7. Hall, *The New Maryland Close Corporation Law*, 27 MD. L. REV. 341, 342 (1967) [hereinafter cited as Hall]. For an example of such authorization, see CODE § 4-401.

8. See, e.g., Hall, *supra* note 7. See also Adickes, *A "Closed Corporation Law" for California*, 54 CALIF. L. REV. 1990 (1966); Bradley, *A Comparative Evaluation of the Delaware and Maryland Close Corporation Statutes*, 1968 DUKE L.J. 525; Latty, *The Close Corporation and the New North Carolina Business Corporation Act*, 34 N.C.L. REV. 432 (1956).

9. See Hall, at 342, 363-64. Corporations having a limited number of stockholders but which have not been organized under special provisions such as Title Four have generally been referred to as "close" or "privately-held" or "closely-held" corporations. Definition of such corporations is not susceptible to precision. Professor F. Hodge O'Neal offers the following definition:

The term "close corporation" has been defined in various ways. It is often used to distinguish and set apart the corporation with only a few shareholders from the "public issue" or publicly held corporation. Another popular definition states that a close corporation is a corporation whose shares are not generally traded in the securities market. One of the few judicial definitions says that the term means "a corporation in which the stock is held in few hands, or in few families, and wherein it is not at all, or only rarely, dealt in by buying or selling."

F. HODGE O'NEAL, OPPRESSION OF MINORITY SHAREHOLDERS § 1.01, at 2 n.1 (1975) (citations omitted). Such corporations, not organized as *statutory* close corporations, are sometimes referred to in this article as "privately-held" corporations. In Maryland, they are organized in accordance with the general corporation provisions set forth in CODE, § 2-101 to -611. These statutory provisions are referred to in this article as the "general corporation law."

10. Hall, *supra* note 7, at 341; *accord*, Bradley, *supra* note 8, at 554.

11. A representative of the Maryland State Department of Assessments and Taxation has informed the author as of the date of this writing that in excess of 1,100 Title Four Corporations have been filed since its enactment (and that the rate of filing has increased recently).

Notwithstanding the chorus of initial praise, and in light of the burgeoning growth of statutory close corporations, a reexamination of the practical implications of the premises underlying the enactment of close corporation statutes would seem to be in order. Practice under the Maryland Act suggests that its purported advantages may be more myth than reality. Indeed, nine years of experience with the problems typically confronting Title Four corporations tends to support the conclusion that commitment to this business mold may be largely unrealistic and impracticable in light of the vagaries of human nature.

This article will seek to balance the scales of understanding respecting statutory close corporations. First, it will analyze the dangers inherent in organizing and operating under statutes like Maryland's Title Four. Second, it will demonstrate that almost all of the corporate planning flexibility deemed by some to be possible only under the aegis of the close corporation statutes is actually afforded by the provisions of the general corporation law. Finally, a minimal modification of the general corporation law will be suggested. This modification would inject into that law perhaps the sole practical advantage now available under Title Four which is not presently available under the former.

I. CLOSE CORPORATION DANGERS

A business enterprise should not be committed to close corporation status without a clear understanding of the potential problems that may arise as a result of that election. Close corporation statutes tend to reflect an inadequate grasp of the critical role played by the personalities and private motivations of the participants in any "small" business. The prime danger is that the Title Four unanimous stockholders' agreement provisions,¹² coupled with other built-in "deadlock" provisions,¹³ may, as a practical matter, deflect corporate counsel from cautious planning specifically designed to minimize intra-corporate stockholder conflict. Moreover, elimination of the traditional board of directors structure may promote management informalities to a degree that actually exacerbates stockholders' controversies and leads to other potentially adverse consequences.

12. CODE § 4-401. See note 57 and accompanying text *infra*.

13. See note 2 and accompanying text *supra*.

A. *Deadlock and the Avoidance of Corporate
Planning Responsibilities*

The theme of *unanimity* is a significant characteristic of close corporation statutes, including Maryland's Title Four; to proponents of such statutes, it is perhaps second in importance only to the statutory validation of the stockholders' agreement.¹⁴ Actions respecting each of seven vital corporate matters may be taken, subject to minor variation, only by the affirmative vote or consent of every stockholder.¹⁵ These matters include the consolidation, merger, and transfer of assets of the corporation,¹⁶ stock issuance,¹⁷ and certain transfers of stock.¹⁸ Removal from the charter of the "statement of election to be a close corporation" requires not only unanimous stockholder approval, but also the approval of "every subscriber for stock of the corporation."¹⁹ Furthermore, adoption of amendments to the unanimous stockholders' agreement requires the concurrence of all parties to the agreement.²⁰

For most of the enumerated transactions, the requirement of a unanimous vote may be varied neither by the corporate charter nor by the unanimous stockholders' agreement.²¹ Even in those limited instances where the statute does permit modification, it may have little practical effect. For example, the statute permits transfers of stock to certain persons designated in the stockholders' agreement.²² Nevertheless, unless the specific transfer is designated in the stockholders' agreement, unanimous stockholder approval must be obtained at the time that any such transfer is sought to be implemented.²³ Similarly, with respect to the matter of a stock issuance, the Maryland Act requires approval by the holders of *all* outstanding stock unless the issuance is permitted by the unanimous stockholders' agreement.²⁴

14. See Hall, *supra* note 7, *passim*. See also Comment, *Desirability of a "Close Corporation Act,"* 52 Nw. U.L. Rev. 397, at 401-02 (1957). Although Professor Hall does not specify unanimity as second in importance, his article as a whole suggests such an inference. He does, however, express some reservations respecting unanimity. See notes 26 & 42 and accompanying text *infra*.

15. CODE § 4-504(b); notes 16-20 *infra*.

16. *Id.* § 4-601.

17. *Id.* § 4-501.

18. *Id.* § 4-503.

19. *Id.* § 4-203.

20. *Id.* § 4-401(b).

21. *Id.* § 4-504(b).

22. *Id.* § 4-503(b) (2).

23. *Id.* § 4-503(b) (1).

24. *Id.* § 4-501.

Assuming that statutory standards for these matters are not, in fact, modified by the stockholders' agreement at the time of incorporation, an amendment of the stockholders' agreement at a later date to achieve such modifications will require the concurrence of all stockholders party to the agreement.²⁵

In practice, the unanimity requirements respecting stock issuance and transfer tend not to be modified by stockholders' agreements.²⁶ Perhaps one reason for this is traceable to the contention of Title Four advocates that such requirements serve as a protection to existing stockholders against the introduction of new and unwanted "partners."²⁷ However, this contention ignores the fact that, at a time subsequent to incorporation, a needed infusion of capital or necessary skill from a would-be stockholder could be effectively blocked if a single stockholder were to find the individual personally offensive. While it is clearly not desirable for incompatible individuals to associate in a business enterprise, it should be recognized that the continued viability of the enterprise may well dictate association with persons who are approved of by some but not all existing stockholders. On the day of incorporation it might appear to be an advantage to give to each stockholder a veto over future stock issuances. Nevertheless, at a later date, this veto power may be exercised for arbitrary or inappropriate personal reasons thus cutting the corporation off from essential financing or expertise, seriously damaging the corporation or even bringing about its demise.

For example, assume that a corporation has been organized to engage in a vital new industry and has less than ten stockholders. As time passes, it becomes apparent that the corporation will have to undertake an offering of securities in order to raise needed capital (and to achieve a cross-section of community interest among its stockholders²⁸). The contemplated sale of securities to additional

25. *Id.* § 4-401(b).

26. The author made a random sample review of twenty-nine Title Four corporations by contacting persons named as incorporators in the articles of incorporation filed with the State Department of Assessments and Taxation. Of those corporations, twenty-six either had no stockholders' agreement or named no one other than the initial stockholders as potential transferees. Moreover, even if an attempt were made to modify the statutory stock issuance requirements, only the most prophetic of persons could account for all possible contingencies. Professor Hall himself recognizes the problems inherent in unanimity requirements affecting stock issuance and transfer. *See* Hall, *supra* note 7, at 352-53, 356.

27. Hall, *supra* note 7, at 348, 352.

28. There may be certain non-corporate law qualifications imposed upon a business by virtue of its field of endeavor. For example, a criterion considered in granting a community-wide communications franchise may be that persons representing different

stockholders will trigger one of the Title Four unanimity requirements.²⁹ Another unanimity provision will come into play because the close corporation election will have to be removed from the charter,³⁰ the close corporation commitment to vetoes being totally alien to operating a business with a dozen stockholders or perhaps even half that number.³¹ Only one of the corporation's existing stockholders opposes the admission of new stockholders. Yet his failure to approve will block the transaction. Significantly, the obstreperous stockholder's opposition comes neither from disagreement with the corporate policies and goals nor from objections to the prospective stockholders. Rather, his intransigence stems from his disagreement with the corporation's management respecting payments allegedly due him for past services rendered to the corporation. He refuses to accede to the necessary changes unless his request for compensation is granted. Because the other stockholders are not in a financial position to repurchase this stockholder's shares pursuant to the special close corporation dissolution provision,³² the corporation will have no alternative but to succumb to his demands in order to achieve the business objectives of all the stockholders. This example highlights the importance an enterprise's original stock-

interests in the community own stock in the corporation. See *Two Groups Seek Franchise For Howard Cable TV*, The [Baltimore] Sun, Nov. 1, 1972, § C, at 24, col. 7; *Calvert Get County Cable Franchise*, The [Baltimore] Sun, Apr. 3, 1973, § A, at 1, col. 7; *Howard CATV Guarantees Asked*, The [Baltimore] Sun, Mar. 9, 1973, § C, at 7, col. 5; *CATV Applicant Stresses Local Sale Stock Plan*, The [Baltimore] Evening Sun, Mar. 9, 1973, § C, at 3, col. 6; *Howard CATV Franchise Goes to Local Group*, The [Baltimore] Evening Sun, Sept. 5, 1973, § D, at 2, col. 4; *Costs, Control are Issues in Howard CATV Hearings*, The [Baltimore] Sun, Mar. 13, 1973, § A, at 11, col. 1.

29. CODE § 4-501. Even if the stockholders' agreement permitted issuances to certain named persons, unanimity would still be required respecting an issuance to any person not so named. See also notes 23-24 and accompanying text *supra*.

30. *Id.* § 4-203.

31. With respect to the workability of unanimity in relation to the number of stockholders, Professor O'Neal states:

The risk of deadlock of course grows as the number of shareholders increases. If a corporation is to have more than four or five shareholders, it may be unwise to give a single shareholder power to veto corporate action. In a corporation with seven shareholders and a seven man board, for instance, it may be preferable to set the vote for shareholder and director action in a way which requires concurrence of two shareholders or directors to effect a veto.

O'NEAL, *supra* note 9, § 8.09, at 562.

32. CODE § 4-603.

holders should attach to the implications of the unanimity requirements that would be imposed on them by a Title Four election.³³

Equally, if not more, limiting than the requirements relating to stock issuance or transfer is the mandate that a statutory close corporation cannot at any time undertake such extraordinary corporate actions as a merger or transfer of assets without the unanimous approval of all stockholders.³⁴ While it may be prudent to impose a unanimity requirement respecting such organic transactions when only two or three persons own stock in a corporation,³⁵ such a requirement may have deleterious consequences when five or ten stockholders are involved in an enterprise. In the latter instance a substantial affirmative vote requirement, requiring approval by two-thirds or three-fourths of the shares may be preferable to unanimity. Otherwise, a single dissident minority stockholder in a statutory close corporation could effectively veto the transaction, instead of being relegated to exercising the objecting stockholder's fair appraisal remedy under the general corporation law.³⁶

Unanimity, in and of itself, is not objectionable. The potential benefits of stockholder unanimity provisions, particularly in guarding against the oppression of minority stockholders, cannot be denied. At the time of incorporation, however, a careful analysis may indicate that a combination of corporate plans for growth coupled with an

33. Professor O'Neal, although not taking a firm position against unanimity, does emphasize the danger of unanimity and high voting requirements as follows:

First, a shareholder with a veto may use his veto power to extort unfair concessions from his associates as a condition to giving his approval to desired corporate action. Second, veto arrangements deprive a corporation of flexibility which it may need to adjust to new situations. Third, high vote requirements greatly increase the chance of deadlock and corporate paralysis and raise the difficult question of what arrangements can be set up to break deadlocks when they develop.

O'NEAL, *supra* note 9, § 8.09, at 562 (footnotes omitted).

34. CODE § 4-601.

35. The concept of making unanimity selectively applicable to certain types of major corporate transactions would apply equally to both the Title Four Corporation and the privately-held corporation.

36. CODE § 3-202 (right of stockholders dissenting from certain specified extraordinary corporate matters to receive the "fair value" of their shares). For an example of an emerging alternative to the objecting stockholders' fair appraisal remedy under the Federal Securities Laws, see *Green v. Santa Fe Industries, Inc.*, Current CCH FED. SEC. L. REP. ¶ 95,447 (2d Cir. 1976); *Marshel v. AFW Fabric Corp.*, Current CCH FED. SEC. L. REP. ¶ 95,448 (2d Cir. 1976). The Court of Appeals for the Second Circuit held in these cases that minority stockholders were entitled to relief under rule 10b-5 when majority stockholders utilized short-form mergers or similar devices solely to squeeze the minority out of a corporation by forcing them to relinquish their stockholdings for the "fair appraisal" price. This alternative, however, would be applicable only to unfair "squeeze-outs" of minority stockholders.

appreciation of the potential disadvantages of unanimity requirements dictate the use of substantial, but less than unanimous, affirmative voting requirements to avoid the possibility that corporate growth may be stunted due to the negativism of one disgruntled stockholder. The general corporation law permits modification of voting requirements for individual corporate actions, including the option to select unanimity.³⁷ Such flexibility is not available under the blanket unanimity requirement of Title Four. Hence, as will be discussed in Part II, it may well be that flexibility in corporate planning is actually more characteristic of a privately-held corporation than of a statutory close corporation. The frustration of being locked into the unanimity format is intensified when a stockholder is confronted with an unforeseen contingency requiring the elimination of unanimity, either through amending the agreement or amending the charter to terminate the close corporation election. The stockholder must contend with a "Catch 22" situation: such a result can only be reached through a unanimous agreement.³⁸

B. *The Problems of Relaxing Corporate Formalities*

Close corporation proponents are careful to emphasize that a statute such as Maryland's Title Four "eliminates or relaxes certain formalities and standard procedures which are unnecessary in the case of the small corporation."³⁹ Among other things, the traditional managing board of directors, directors' meetings, and annual stockholders' meetings are not required of statutory close corporations.⁴⁰ The paucity of documentation set forth in close corporation minute books⁴¹ suggests that, in practice, this relaxation of requirements frequently has been interpreted as eliminating the need to maintain adequate records of corporate action.

37. The requirement that certain major corporate acts be approved by the affirmative vote of two-thirds of all the votes entitled to be cast on the matter, CODE § 3-105(d), may be modified to require the concurrence of a greater proportion of the votes or a lesser proportion of the votes (but this may not be less than a majority of all the votes to be cast). *Id.* § 2-104(b) (4) & (5).

38. CODE § 4-203.

39. Hall, *supra* note 7, at 342.

40. CODE §§ 4-302, 4-402.

41. See note 26 and accompanying text *supra*. In making the random review referred to in note 26 *supra*, the author discovered little or no documentation of corporate action, other than organizational minutes.

A lack of recorded corporate history may have serious consequences, and prudence, if not the statute,⁴² dictates maintaining such formal records, at least to provide reliable evidence of corporate action which may subsequently be questioned.⁴³ In a corporate enterprise composed of two or more persons, some disputes are bound to arise over, for example, such matters as the rate of compensation to be paid to a stockholder-employee, a fringe benefit which he or she may claim, or an agency authorization for a challenged corporate agreement. Documentation is unlikely to fade as rapidly as memory, which may be warped by such factors as personal differences, attitude changes, or plain greed. Moreover, a corporate history, properly chronicled through minutes, may assist later efforts to obtain debt financing from a bank or to raise equity capital.⁴⁴

42. Although the Maryland statute is not perfectly clear, it appears that formal minutes may be statutorily required even if there is an election to have no board of directors pursuant to CODE § 4-302 because stockholders are nonetheless responsible for those actions which the general corporation law requires of directors. *Id.* § 4-303(2). In particular, under the general corporation law, directors' minutes must be recorded in writing and the books and records must be in at least a form which can be converted into written form for visual inspection. *Id.* § 2-111(a) & (b). Furthermore, the general law requires a corporation to keep, in addition to directors' minutes, "minutes of the proceedings of its stockholders." *Id.* § 2-111(a)(2).

Regardless of formal minutes, books, and records requirements under Title Four, there are other reasons of importance for maintaining such records. One reason is the potential tax consequences. Implicit in the Internal Revenue Code is the necessity for extensive recodation of corporate action taken in compliance with tax requirements. For example, fringe benefit deduction claims by the corporation and corresponding exemption from income claims by its stockholder-employees may be lost by the lack of proper record-keeping. See Treas. Reg. § 1.6001-1(a) (1959) which provides:

[a]ny person subject to tax under subtitle A of the Code, or any person required to file a return of information with respect to income [including corporations], shall keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information.

See also *id.* § 1.6001-1(e) which provides:

The books or records required by this section shall be kept at all times, available for inspection by authorized internal revenue officers or employees, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

These record-keeping requirements suggest the need to maintain minutes respecting the adoption of fringe-benefits such as pension plans or other deductible benefits accorded to employees through employment agreements duly adopted by the board of directors.

43. See 9 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS, § 4617, at 522 (rev. ed. 1964), where the author states that "[c]orporate books and records, when properly authenticated, are the *best evidence* of the acts, resolutions and proceedings of the corporation." (emphasis added).

44. As to the need for corporate records in connection with equity financing, see R. SHAPIRO, A. SACHS & C. OLANDER, SECURITIES REGULATION FORMS, COMPLIANCE-

A frequent problem, not necessarily limited to statutory close corporations, is the failure to set forth stock issuance resolutions in the corporate minute book. The omission of such information not only increases the risk of dispute as to the ownership percentages accorded the various stockholders, but also leads to the loss of a valuable option otherwise available to corporations that have authorized no-par stock. Unless prior to the stock issuance an allocation to capital surplus is resolved by the directors or, in the case of a statutory close corporation without directors, by the stockholders,⁴⁵ the corporation loses the right to create such surplus in connection with that issuance.⁴⁶ Indeed, the absence of such surplus could disable the corporation from a repurchase of its stock⁴⁷ or the declaration of a dividend⁴⁸ at a later date.

Many privately-held corporations probably do not follow the rule of careful record-keeping and the maintenance of formalities. Nevertheless, the clear orientation of the statutory close corporation toward informality makes it even more susceptible to sloppy corporate house-keeping. One potentially critical consideration is that if the corporate house is not in order at the time a challenge is leveled at the limitation on liability of its stockholders the very failure to adhere to a modicum of corporate formality may well be weighed in favor of piercing the corporate veil.⁴⁹ Since Title Four permits statutory close corporations to omit certain formalities, it may be argued that the statutory close corporation is less susceptible to challenges aimed at piercing the corporate veil for failure to maintain formalities. The effectiveness of such an argument is diminished, however, when it is recognized that statutory close corporation stockholders are specifically charged with taking such steps as would otherwise be required of corporate directors in order to implement a corporate action.⁵⁰ Hence, if a close

PRACTICE, § 1.04, at 1-4 & 1-5 (1975). As to such need in connection with debt financing, see Letter from Leonard Richards of the Mercantile-Bank & Trust Company to the author, April 28, 1976.

Other reasons for maintaining proper records are mentioned briefly in note 42 *supra*.

45. CODE § 2-303(b) (2).

46. See note 50 and accompanying text *infra*.

47. CODE § 2-311(d).

48. *Id.* § 2-309(b) (2).

49. Taken alone this failure may not justify disregarding the limited liability of the corporate entity, but it could be a factor in a court's consideration. See, e.g., *Zubik v. Zubik*, 384 F.2d 267 (3d Cir. 1967), *cert. denied*, 390 U.S. 988 (1968). "[S]hareholders as such are, according to the general rule, not liable for corporate torts, but they might be where formalities are not substantially observed, initial financing was not adequate, etc." H. HENN, *Law of Corporations*, § 146, at 254 (2d ed. 1970).

50. CODE § 4-303.

corporation minute book does not set forth in stockholders' minutes what should otherwise be set forth in a privately-held corporation's directors' minutes, then a thread in the corporate veil may well have been pulled.

C. *The Dissolution Process*

Dissolution has been given special treatment under Title Four.⁵¹ Any stockholder may seek dissolution when "there is such internal dissension among the stockholders of the corporation that [its] business and affairs . . . can no longer be conducted to the advantage of the stockholders generally."⁵² Furthermore, a single stockholder may, in the absence of a provision to the contrary in the stockholders' agreement, compel a dissolution if he does not receive the approval required in that agreement for a transfer of his stock.⁵³ The only alternative to such approval or dissolution is for the other stockholders to purchase the shares of the stockholder seeking dissolution. If these stockholders are without the funds to acquire those shares, they may well be compelled to permit the dissolution of their business.

Thus, while the dissolution provisions of Title Four have been characterized as an "important safety valve" for stockholders involved in a "close personal relationship,"⁵⁴ they do not take into account the fact that stockholders in statutory close corporations frequently have limited resources and cannot afford to stave off dissolution despite their desire, and statutory right,⁵⁵ to do so. Moreover, no matter how "close" and "personal" business relationships may be, it is doubtful that they warrant conferring on one stockholder the power to confront the other stockholders with an ultimatum to buy back his stock or suffer dissolution. It may be argued that the Title Four standard for involuntary dissolution obviates frivolous dissolution claims because it requires such a high degree of dissension that the corporation's "business and affairs . . . can no longer be conducted to the advantage of the stockholders generally."⁵⁶ Nevertheless, one stockholder, through his own devices, may generate enough negative feeling among the other stockholders to compel a court finding that dissolution is warranted unless the buy-back provision is exercised.

51. *Id.* §§ 4-602, 4-603.

52. *Id.* § 4-602(a).

53. *Id.* § 4-602(b)(i). Professor Hall suggests that dissolution may be an unsatisfactory method of resolving this dilemma. See Hall, *supra* note 7, at 351.

54. Hall, *supra* note 7, at 361.

55. CODE § 4-603(a).

56. *Id.* § 4-602(a).

The point here, as in the areas requiring unanimity, is that the majority of the stockholders in a statutory close corporation may be subjected to the tyranny of a minority of one.

II. GENERAL CORPORATION LAW ALTERNATIVES TO ACCOMPLISH PURPORTED ADVANTAGES OF CLOSE CORPORATION STATUTE

Do the purported advantages of close corporation status, namely, the planning options of the unanimous stockholders' agreement and the informal modes for taking corporation actions, outweigh its potential disadvantages? A negative answer to this question would seem to be indicated in view of the fact that the same advantages are available to corporations formed under the general corporation law.

A. *Ease of Corporate Planning for the General Practitioner*

To proponents of the statutory close corporation, the clear authorization of the unanimous stockholders' agreement is considered "the most important contribution of [the special] statute"⁵⁷ The section of the Maryland Act governing the contents of the unanimous stockholders' agreement provides:⁵⁸

Under a unanimous stockholders' agreement, the stockholders of a close corporation may regulate any aspect of the affairs of the corporation or the relations of the stockholders, including:

- (1) The management of the business and affairs of the corporation;
- (2) Restrictions on the transfer of stock;
- (3) The right of one or more stockholders to dissolve the corporation at will or on the occurrence of a specified event or contingency;
- (4) The exercise or division of voting power;
- (5) The terms and conditions of employment of an officer or employee of the corporation, without regard to the period of his employment;
- (6) The individuals who are to be directors and officers of the corporation; and
- (7) The payment of dividends or the division of profits.

With only minor qualifications, however, each of these matters may also be regulated under the general corporation law through the

57. Hall, *supra* note 7, at 344.

58. CODE § 4-401(a).

articles of incorporation, the by-laws, and other corporate organizational documents. Taken together, these documents can embody virtually all of the claimed advantages for ordering corporate affairs that are attributed to the close corporation's stockholders' agreement. Indeed, implementation in the general corporation law context may actually prove to be less complicated than drafting a satisfactory unanimous stockholders' agreement.

Despite the assertion that the unanimous stockholders' agreement and the close corporation simplify corporate planning for "the lawyer who is not a corporate expert"⁵⁹ the reverse may be true; by setting forth a broad checklist of permissible provisions for inclusion in the articles of incorporation,⁶⁰ the general corporation law may actually aid the unsophisticated practitioner in assessing and implementing the range of planning options most suitable for achieving clients' objectives. Section 2-104 of the general corporation law provides:⁶¹

The articles of incorporation may include:

- (1) Any provision not inconsistent with law which defines, limits, or regulates the powers of the corporation, its directors and stockholders, any class of its stockholders, or the holders of any bonds, notes, or other securities which it may issue;
- (2) Any restriction not inconsistent with law on the transferability of stock of any class;
- (3) Any provision authorized by this article to be included in the by-laws;
- (4) Any provision which requires for any purpose the concurrence of a greater proportion of the votes of all classes or of any class of stock than the proportion required by this article for that purpose;
- (5) A provision which requires for any purpose a lesser proportion of the votes of all classes or of any class of stock than the proportion required by this article for that purpose, but this proportion may not be less than a majority of all the votes entitled to be cast on the matter;
- (6) A provision which divides its directors into classes and specifies the term of office of each class; and
- (7) A provision of minority representation through cumulative voting in the election of directors and the terms on which cumulative voting rights may be exercised.

59. Hall, *supra* note 7, at 364.

60. CODE §§ 2-103 to 2-105.

61. *Id.* § 2-104(b).

Section 2-105 adds:⁶²

A corporation may provide by its charter :

(1) For one or more classes of stock, the voting rights of each class, and any restriction on or denial of these rights;

(2) As to each class of stock, either the par value of the shares or that the shares are without par value;

(3) (i) That the corporation shall set apart dividends for or pay dividends to the holders of a specified class of stock before any dividends are set apart for or paid to the holders of another class of stock;

(ii) The rate, amount, and time of payment of the dividends; and

(iii) Whether the dividends are cumulative, cumulative to a limited extent, or noncumulative;

(4) That any specified class of stock is preferred over another class as to its distributive share of the assets on voluntary or involuntary liquidation of the corporation and the amount of the preference;

(5) That any specified class of stock may be redeemed at the option of the corporation or of the holders of the stock and the terms and conditions of redemption, including the time and price of redemption;

(6) That any specified class of stock is convertible into shares of stock of one or more other classes and the terms and conditions of conversion;

(7) That the holders of any specified securities issued or to be issued by the corporation have any voting or other rights which, by law, are or may be conferred on stockholders;

(8) For any other preferences, rights, restrictions, including restrictions on transferability, and qualifications not inconsistent with law;

(9) That the board of directors may classify or reclassify any unissued stock from time to time by setting or changing the preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends, qualifications, or terms or conditions of redemption of the stock; and

(10) For any definition, limitation, or denial of the preemptive rights of stockholders to acquire additional stock in the corporation.

62. *Id.* § 2-105.

This list is supplemented by permissible provisions for inclusion in the corporation's by-laws.⁶³ In short, the guidelines expressly furnished by the general corporation law are more exhaustive and explicit than those set forth in the close corporation law. Hence it would seem that, despite contentions to the contrary, the former may assist the non-experienced practitioner far more than the latter.

But if Title Four does not facilitate corporate planning for "the lawyer who is not a corporate expert,"⁶⁴ does it offer any significant substantive advantages to the privately-held corporation that are not offered by the general corporation law? This question can only be answered by a comparison of the planning possibilities available under close and general corporate law.

B. *Unanimity and Deadlock Possibilities*

As has been demonstrated, the blanket unanimity provided by Title Four can prove to be extremely dangerous in practice. Nevertheless, the protection of minority stockholders' interests against oppression by the majority⁶⁵ may warrant the selective use of unanimity and high voting requirement provisions. The general corporation law accords the corporate planner the option of imposing unanimity in each of the areas for which it is required under Title Four.⁶⁶ Thus, where minority stockholders fear exclusion from the corporate decision-making process on certain vital matters, the general corporation law would permit the inclusion in the articles of incorporation of a provision specifically enumerating such matters and ex-

63. The general corporation law is engulfed in "unless otherwise provided" provisions. See, e.g., CODE § 2-109(b) (subsequent by-laws to be adopted by the stockholders unless the charter or by-laws provide that the board of directors shall do so); *id.* § 2-204(a) (corporation may not issue stock for convertible securities in violation of a limitation or restriction contained in its charter or by-laws); *id.* § 2-204(c) (charter or by-laws may require stockholder approval for the issuance of stock as a stock dividend); *id.* § 2-213 (by-laws may alter or modify the power of the board of directors to issue new stock certificates upon the loss, theft, or destruction of existing certificates); *id.* § 2-401(b) (board of directors may exercise all powers of the corporation except those reserved to the stockholders by law or by the charter or the by-laws of the corporation); *id.* § 2-403 (qualifications of directors may be prescribed by the charter or by-laws); *id.* § 2-404(b) (2) (term of office may be provided in the by-laws subject to certain limitations contained in this statutory section).

64. Hall, *supra* note 7, at 364. This proposition should be considered in light of note 89 and accompanying text *infra*.

65. For a discussion on certain cautions to be taken in using high vote requirements see O'NEAL, *supra* note 9, § 8.09, at 562.

66. See note 58 and accompanying text *supra*.

pressly providing for unanimity in decisions thereon.⁶⁷ Moreover, the general corporation law, unlike Title Four, permits a designation, within certain limits, of the vote required to approve each kind of major corporate transaction. Thus, if the corporate needs warrant the inclusion of such provisions, a different voting requirement — ranging from a majority of the shares entitled to vote to unanimous approval of the shares entitled to vote — may be incorporated for each of the enumerated transactions.⁶⁸

The principals in a privately-held corporation might decide that neither substantial nor unanimous affirmative stockholder voting requirements would be appropriate. Rather, they might conclude that the decisions of a majority stockholder should bind all of the stockholders. Nevertheless, opting for majority stockholder approval need

67. Such a provision might read:

The following provisions are hereby adopted for the purpose of defining, limiting, and regulating the powers of the corporation and of the directors and stockholders thereof:

(1) With respect to:

- (a) the amendment of the charter of the Corporation,
- (b) the consolidation of the Corporation with one or more other corporations to form a new consolidated corporation,
- (c) the merger of the Corporation into another corporation or the merger of one or more other corporations into the Corporation,
- (d) the sale, lease, exchange, or other transfer of all, or substantially all, of the property and assets of the Corporation, including its goodwill and franchises,
- (e) the voluntary or involuntary liquidation, dissolution, or winding up of the Corporation,
- (f) the issuance of shares of stock of any class now or hereafter authorized, or of any securities exchangeable for, or convertible into such shares, or of warrants or other instruments evidencing rights or options to subscribe for, or otherwise acquire such shares, and
- (g) the amendment of the By-Laws of the Corporation,

any such action shall be effective and valid only if taken by a unanimous vote of all the shares of capital stock outstanding at the time of such action, after due authorization, approval or advice of such action by the Board of Directors as required by law, notwithstanding any provision of law requiring any action to be taken or authorized by the stockholders other than as provided in this Article. See CODE § 2-104(b) (4) (allowing the concurrence of a greater proportion of the votes of all or any class of stock than the proportion set out in the Article).

Furthermore, the articles of incorporation may divide a corporation's directors into classes under section 2-104(b) (6) or may contain "[a] provision for minority representation through cumulative voting in the election of directors . . ." under section 2-104(b) (7). Being represented on the board of directors gives minority stockholders at least a chance to present their views. Also, by virtue of holding a seat on the board, a minority stockholder may be accorded full inspection rights. See *In re Cohen v. Cocoline Products, Inc.*, 309 N.Y. 119, 127 N.E.2d 906 (1955); accord, 5 FLETCHER, *supra* note 43, § 2235, at 872.

68. CODE § 2-104(b) (4) & (5). See also note 37 and accompanying text *supra*.

not preclude protection of minority interests in some aspects of the decision-making process. The general corporation law permits flexibility in the use of classes of stock and classes of directors to give minority as well as majority stockholders the power to elect members of the board of directors and, through them, to participate in, or at least to be kept abreast of, corporate management decisions.⁶⁹ For example, by utilizing three classes of stock, each of which would be identical in all respects except as to the election of directors, minority stockholders could be given the right to elect a director who would represent their class of stock, while the majority stockholders would hold a class of stock entitled to elect a clear majority of directors.⁷⁰ If minority stockholders make known at the planning

69. *Id.* § 2-104(b) (6). See note 67 *supra*. It should be noted that utilization of different classes of stock could cause a corporation with ten or fewer stockholders to lose the right to elect Subchapter S status under the Internal Revenue Code. See note 110 *infra*. Nevertheless, if it is desired that a privately-held corporation achieve both minority stockholder representation on the board of directors and Subchapter S status, such objective can be implemented through the inclusion of cumulative voting provisions in the charter. Such provisions avoid the Subchapter S prohibition on classes of stock.

70. The following provision could be included in the Articles of Incorporation to designate classes of directors to be elected by specified classes of stockholders:

The total number of shares of capital stock which the Corporation has authority to issue is 30X divided into 10X shares of Class A Common Stock without par value (the "Class A Common Stock"), 10X shares of Class B Common Stock without par value (the "Class B Common Stock") and 10X shares of Class C Common Stock without par value (the "Class C Common Stock"). The following is a description of each class of stock of the Corporation with the preferences, conversion and other rights, restrictions, voting powers and qualifications of each class:

- (1) With respect to the election of the Board of Directors of the Corporation:
 - (a) the holders of Class A Common Stock (i) shall nominate and elect one (1) director who shall be known as the Class A Director, and (ii) in the event of the death, disability, removal, resignation or refusal to act of the Class A Director, the holders of Class A Common Stock, to the exclusion of the holders of all other classes of stock of the Corporation, shall nominate and elect a director to fill the vacancy so created by such death, disability, removal, resignation or refusal to act;
 - (b) the holders of Class B Common Stock (i) shall nominate and elect one (1) director who shall be known as the Class B Director, and (ii) in the event of the death, disability, removal, resignation or refusal to act of the Class B Director, the holders of Class B Common Stock, to the exclusion of the holders of all other classes of stock of the Corporation, shall nominate and elect a director to fill the vacancy so created by such death, disability, removal, resignation or refusal to act; and
 - (c) the holders of Class C Common Stock (i) shall nominate and elect three (3) directors who shall be known as the Class C Directors, and (ii) in the event of the death, disability, removal, resignation or refusal to act of any or all of the Class C Directors, the holders of

stage their desire to have rights beyond such management selection, a combination of classes of stock and adjustments for high voting requirements on selected matters could be utilized to accord them even more protection.

Another potential fear of minority stockholders is that director or stockholder meetings may be held, and corporate transactions undertaken, in their absence. By not participating in such meetings they may be deprived of the flow of important corporate information. Notice of meetings may do little to solve this problem as the meetings may nonetheless be held at times or places inconvenient to minority stockholders. The general corporation law resolves this dilemma by permitting the implementation of high or unanimous quorum requirements in the by-laws to protect minority interests from oppression⁷¹ based upon exclusion of the minority from meetings.

At times, the corporate planner may be charged with protecting the interests of the majority rather than of the minority.⁷² For instance, all participants in a privately-held corporation may agree that in order to implement corporate objectives the minority stockholders are to have no more than a financial interest in the corporation. In

Class C Common Stock, to the exclusion of the holders of all other classes of stock of the Corporation, shall nominate and elect one or more directors to fill the vacancy or vacancies so created by such death, disability, removal, resignation or refusal to act.

- (2) Except as hereinabove provided in paragraph (1) of this Article, the Class A Common Stock, the Class B Common Stock and the Class C Common Stock of the Corporation shall be identical in all respects and for all purposes and the holders of Class A Common Stock, the holders of Class B Common Stock and the holders of Class C Common Stock voting together and without distinction as to class shall be entitled to one vote per share in all proceedings in which actions shall be taken by the stockholders of the Corporation.

The number of directors of the Corporation shall be five (5). The names of the directors who shall act until the first annual meeting of the stockholders of the Corporation and until their successors are duly chosen and qualified and the class of Common Stock which they represent are:

CLASS A DIRECTOR
V

CLASS B DIRECTOR
W

CLASS C DIRECTORS
X
Y
Z

⁷¹ CODE § 2-408(b)(1), which provides: "Unless the by-laws of the corporation provide otherwise, a majority of the entire board of directors constitutes a quorum for the transaction of business." (emphasis added). An appropriate protective by-law provision such as that relating to a unanimous quorum, may be insulated from amendment by high or unanimous voting requirements for amendments. See notes 89-90 and accompanying text *infra*.

⁷² Frequently a lawyer representing a corporation inadvertently may attempt to act for all potential stockholders, although they may have divergent interests by virtue, for example, of their majority and minority status.

this situation, the objective of corporate planning would be to allocate all voting rights to majority stockholders. Under the general corporation law, a combination of voting and non-voting stock can be used to limit the minority's rights to any non-financial incidents of stock ownership.⁷³ This objective, however, cannot be achieved under the close corporation statute, for although Title Four allows the designation of non-voting stock, such designation cannot operate to preclude the holders of any stock from voting on those matters which require unanimous stockholder approval.⁷⁴ As these examples show, the pattern of rights and protections built into the close corporation statute is fixed to a significant extent, while the potential for variation in allocating rights to majority and minority interests is virtually limitless under the general corporation law.

C. *Limitations Upon the Transfer of Stock*

Title Four imposes certain statutory restrictions on stock transfers⁷⁵ and allows the stockholders' agreement to include further restrictions.⁷⁶ The Maryland general corporation law permits articles of incorporation to embody any or all of the restrictions required and permitted under Title Four.⁷⁷ Similarly, the traditional privately-held corporation "buy-sell" or "restrictive transfer" agreement may contain such restrictions on stock transfer.⁷⁸ "Reasonable" stock

73. CODE § 2-105(1) & (3). As to the denial of Subchapter S status by virtue of the use of classes of stock, see note 69 *supra*.

74. *Id.* § 4-504(a) which states in pertinent part: "Notwithstanding any denial or restriction, all stock has voting rights on any matter required by this title to be authorized by the affirmative vote of every stockholder or every subscriber for stock of a close corporation."

75. *Id.* § 4-501.

76. *Id.* § 4-401(a) (2).

77. *Id.* § 2-104(b) (2).

78. A "buy-sell" or "restrictive stock transfer" agreement generally imposes restrictions on the sale of stockholdings by stockholders in a privately-held corporation. These restrictions, usually requiring that a withdrawing or deceased stockholder's estate sell stock back to the corporation or the remaining stockholders, are directed at preventing unwanted persons from participating in a closely held business entity. In contrast to broadly drawn stockholder agreements covering a wide range of corporate matters including control, these agreements have not been voided because they do not affect the corporate decision making processes. Nevertheless, restrictive stock transfer and buy-sell agreements must be drafted with an eye toward the common law principle that "unreasonable restrictions upon alienation are unenforceable." Ghinger, *Shareholders Agreements for Closely Held Corporations: Special Tools for Special Circumstances*, 4 U. BALT. L. REV. 211, 215 (1975). 1 F. HODGE O'NEAL, CLOSE CORPORATIONS § 5.29, at 101 (1971) indicates that "[t]ransferees with knowledge of a shareholders' agreement probably will be held to be bound by it." As a protection to later enforceability the CODE § 2-211(d) requires that share certificates subject to shareholders' agreements be appropriately legended so as to give proper and actual notice.

transfer restrictions have long been recognized as valid apart from and without regard to the provisions of Title Four.⁷⁹

Because of their simplicity and automatic applicability the Title Four statutory stock transfer restrictions are susceptible to being construed as comprehensive in their coverage; that is, they might be unquestioningly considered to provide all the protection possible from stock transfer restrictions unless scrutinized by an experienced eye. By contrast, however, the absence of such provisions under the general corporation law should serve to induce the corporate planner and clients to assess their needs more realistically. They may well consider a much wider range of possibilities than those envisioned by Title Four, and may ultimately provide for stock transfer restrictions and buy-sell provisions that afford much more protection to all participants.⁸⁰ It would seem that adhering to set statutory restrictions rather than conforming to individual circumstances simply to reduce lawyer burdens is inimical to professional responsibility.⁸¹

There is another significant advantage to setting forth stock transfer restrictions in general corporation buy-sell agreements or in the articles of incorporation. The stockholders are accorded flexibility as to the basis upon which a change in such restrictions may be effectuated at a later date. While a Title Four unanimous stockholders' agreement may not be amended unless all the parties to the agreement approve,⁸² a general corporation law buy-sell agreement or charter provision can allow for later amendment by less than unanimous approval.⁸³ Such terms for amendment ensure that provisions which ultimately may emerge as unworkable or unrealistic or which may warrant periodic revision, including, in particular, provisions

79. O'NEAL, *supra* note 9, § 6.04, at 378; 2 O'NEAL, *supra* note 78, § 7.07, at 18. See generally 12 FLETCHER, *supra* note 43, § 5461.1, at 192.

80. Professor Hall himself suggests the advisability of utilizing the "stock purchase" agreement in lieu of relying upon Title Four stock transfer restrictions. Hall, at 351. Although allowing one stockholder the power to force a buy-back-my-stock-or-dissolve-the-corporation situation is not herein advocated, see notes 34-36 and accompanying text *supra*, it should be noted for the advocates of such a position that the buy-sell agreement may be utilized to accomplish the same result as the buy-back provisions of Title Four.

81. Cf. ABA CODE OF PROFESSIONAL RESPONSIBILITY, DR-6-101(A)(1) (1970). ("A lawyer shall not . . . [h]andle a legal matter which he knows or should know that he is not competent to handle, without associating with him a lawyer who is competent to handle it.")

82. CODE § 4-401(b).

83. Shareholders' agreements may provide for whatever voting requirements respecting amendment the parties wish. See generally O'NEAL, *supra* note 78, § 5.19, at 72-76.

relating to valuation of shares, may be altered on the approval of some pre-designated number of stockholders.

D. *Other Matters and the Unanimous Stockholders' Agreement*

Title Four permits the unanimous stockholders' agreement to regulate "[t]he management of the business and affairs of the corporation."⁸⁴ This provision follows logically from the elimination of the board of directors by permitting corporate management to be vested in the stockholders.⁸⁵ It must be remembered, however, that if the stockholders' agreement permits the stockholders to assume corporate management duties, they are then required by Title Four to act on any matters upon which a board of directors would otherwise be required to act.⁸⁶

In a privately-held corporation, the stockholders are frequently directors and are therefore vested with the authority to manage the business and affairs of the corporation by virtue of their dual positions. Further, the general corporation law permits the allocation of specific management responsibilities to individuals within the corporate framework. By-law provisions may delegate to specific stockholder-officers the authority to enter certain types of designated transactions, and may allocate authority over particular functions or areas of management responsibility among the individual corporate officers.⁸⁷ For example, in a manufacturing company, design might be delegated to the president, marketing and production to the vice-president, and finance to the secretary-treasurer, all of whom are stockholders who desire to agree upon management functions in advance.⁸⁸ In order to assure that the authority and responsibility allocated to specific officers in the privately-held corporation are not later rescinded by the board of directors,⁸⁹ the charter or by-laws could provide that their amendment or the amendment of these particular authorization provisions may only be effectuated by the unanimous vote of the board of directors or the stockholders.⁹⁰

84. CODE § 4-401(a)(1). Although not entirely logical, it is possible under Title Four to maintain a board of directors and yet delegate management to the shareholders.

85. *Id.* § 4-303(1).

86. *Id.* § 4-303(2).

87. *Id.* § 2-414(a).

88. See generally D. HERWITZ, BUSINESS PLANNING 40-44 (1966).

89. CODE § 2-414(a)(2).

90. *Id.* § 2-414(a). See also HERWITZ, *supra* note 88, at 39-40, where the author states:

A possible solution to this problem is suggested by the fact that a party who has control of at least one-half of the board of directors would seem to be entirely safe . . . since he can prevent any affirmative action terminating his employment.

Moreover, as has been discussed,⁹¹ a privately-held corporation may utilize classes of stock coupled with classes of directors⁹² or classes of voting and non-voting stock⁹³ to divide and subdivide specific management responsibilities. If it were desired that certain stockholders have all management responsibilities, this could be achieved under the general corporation law by issuing all of the corporation's voting stock to those stockholders, thereby providing them with sole management authority. Such a provision could accomplish the same objective as a Title Four stockholder agreement provision delegating management responsibilities to specific stockholders, while at the same time providing for "[t]he exercise or division of voting power" and designating "[t]he individuals who are to be directors and officers of the corporation."⁹⁴

The general corporation law explicitly authorizes a specific type of management allocation agreement — the voting trust agreement.⁹⁵

Every employee who is also a director can obtain the same veto power over changes in his position or salary under a provision requiring a unanimous vote of the board of directors for any action affecting his employment arrangement.

Provisions requiring a higher than majority vote for action by the board of directors of a closely held corporation have been receiving increasingly sympathetic treatment from the courts. Compare *Katcher v. Ohsman*, 26 N.J. Super. 28, 97 A.2d 180 (1953), with *Benintendi v. Kenton Hotel*, 294 N.Y. 112, 60 N.E.2d 829 (1945). In addition, many modern corporation statutes appear to expressly contemplate either a certificate of incorporation or by-law provisions requiring a higher than majority vote by the directors, [as does Maryland under § 2-414].

....

At the board of director level, as at the shareholder level, the practical effect of veto power may be achieved by setting a high quorum requirement for action by the directors [citation omitted]. A provision requiring the presence of all of the directors for a quorum would in effect give every director veto power, since each could block any action by the board simply by staying away from the meeting.

91. Notes 69-70 & 72-73 and accompanying texts *supra*.

92. CODE § 2-104(b) (6).

93. *Id.* § 2-105(1). As to the denial of Subchapter S status because of the use of classes of stock, see note 110 *infra*. It is particularly important to note that the use of these control-classes of stock devices do not disadvantage the privately-held corporation any more than the Title Four corporation by virtue of the non-availability of Subchapter S. See note 110 *infra*.

94. CODE § 4-401(a) (4) & (6).

95. *Id.* § 2-510 which provides:

One or more stockholders of a corporation may confer the right to vote or otherwise represent their stock to a trustee for a period not exceeding ten years by:

- (1) Entering into a written voting trust agreement which specifies the terms and conditions of the voting trust;
- (2) Depositing an executed copy of the agreement with the corporation at its principal office; and
- (3) Transferring their stock for purposes of the agreement to a trustee.

If desired, a voting trust may vest in one stockholder, subject to traditional fiduciary duties,⁹⁶ all the voting power of the corporation. By specifically authorizing the allocation of rights to voting trustees through voting trust agreements, the general corporation law gives the stockholders of a privately-held corporation another correlate to Title Four management regulation and control.⁹⁷ The specific statu-

96. *Brown v. McLanahan*, 148 F.2d 703, 706 (4th Cir. 1945), ("[i]t is elementary that a trustee may not exercise powers granted in a way that is detrimental to the *cestuis que trustent*"). See also 5 FLETCHER, *supra* note 43, § 2091.1, at 436, where he states that "[v]oting trustees should be held to adhere to the usual fiduciary principles of a trust." The same fiduciary duties should also apply to shareholders vested with management under Title Four.

97. As an example of the thoroughness which voting trusts may embody, the following clause may be included in the voting trust agreement:

Limitation Upon Voting Rights of Voting Trustee.

(a) Notwithstanding anything to the contrary provided for herein, in the event that the Board of Directors of the Corporation shall have duly authorized or approved or advised as required by law, the:

(i) amendment of the Charter of the Corporation;

(ii) consolidation of the Corporation with one or more other corporations (other than wholly owned subsidiaries of the Corporation) to form a new consolidated corporation;

(iii) merger of the Corporation into another corporation (other than wholly owned subsidiaries of the Corporation) or the merger of one or more other corporations (other than wholly owned subsidiaries of the Corporation) into the Corporation;

(iv) sale, lease, exchange, or transfer of all, or substantially all, of the property and assets of the Corporation, including its goodwill and franchises;

(v) voluntary or involuntary liquidation, dissolution, or winding-up of the Corporation;

(vi) issuance of shares of stock of any class now or hereafter authorized, or any securities exchangeable for, or convertible into such shares, or warrants or other instruments evidencing rights or options to subscribe for, or otherwise acquire such shares;

(vii) redemption by the Corporation of shares of its own stock or the purchase or other acquisition by the Corporation of its own shares;

(viii) a purchase by the Corporation, other than in the ordinary course of business, of property and assets at a cost equivalent to or greater than Y percent of the net worth of the Corporation as reflected on the balance sheet, prepared by the Corporation's regularly employed accountants, most recent to the date of such purchase;

(ix) investment by the Corporation, through the acquisition of shares of capital stock, partnership interest or otherwise, in other business entities, except with respect to the establishment by the Corporation of wholly-owned subsidiaries and investment in affiliated entities which engage primarily in [business of corporation], and the investment by the Corporation in certificates of deposit or other obligations of banking, savings and loan, and other similar lending institutions whose accounts are insured by an instrumentality of the government of the United States and in obligations of the government of the United States, and in prime finance paper of corporations rated A1 by Moody's Investors Service, Inc. and rated P1 by Standard and Poor's Corp.;

(x) amendment of any employment agreement, or the alteration of the terms set forth therein, as shall be entered into between the Corporation and

tory authorization of the voting trust agreement should dispel any doubt concerning the vesting of corporate control in one stockholder for a period of as long as ten years.⁹⁸

The unanimous stockholders' agreement may also specify the "terms and conditions of employment of an officer or employee of the corporation, without regard to the length of the period of his employment."⁹⁹ While, unquestionably, any corporation has the power to hire employees and appoint officers,¹⁰⁰ the validity of long-term employment contracts for officers has been challenged, generally on the ground that "they bind the hands of future boards of directors."¹⁰¹

[Name of Voting Trustee] except with respect to any insurance, pension or other fringe benefit programs maintained for the benefit of executive personnel;

(xi) making of any loans or advances by the Corporation other than to employees and suppliers in the ordinary course of business; or

(xii) amendment of the By-Laws of the Corporation if such amendment adversely affects the contract rights of any stockholders of the Corporation; then, the Voting Trustee shall promptly call a meeting of all holders of voting trust certificates and shall, not less than fifteen (15) days prior to the date of such meeting, give written notice of such meeting to all holders of voting trust certificates which notice shall include a brief summary of the action to be taken at such meeting, and the following provisions shall apply with respect thereto: the Voting Trustee shall deliver to each respective holder of a voting trust certificate or to his attorney-in-fact (who shall exhibit to the Voting Trustee a duly executed power of attorney with respect thereto) in attendance at such meeting a proxy (entitling such voting trust certificate holder to vote as hereinafter provided) of the Voting Trustee for the specific purpose of permitting such voting trust certificate holder to vote upon the matter designated in the written notice hereinabove referred to, and at said meeting each respective holder of a voting trust certificate who shall have so received a proxy shall be entitled to cast that number of votes equal to the number of shares that the Voting Trustee shall hold pursuant to this voting trust agreement for such respective holder of a voting trust certificate. The Voting Trustee shall be entitled to cast all votes, in accordance with his best judgment, represented by shares with respect to which he has not been required to deliver a proxy pursuant hereto.

Items (i) to (xii) are intended to serve as model provisions only; the ultimate protective provisions adopted in any voting trust would depend upon the individual circumstances of the prospective voting trust certificate holders.

98. CODE § 2-510. Presumably ten years, the statutory time for voting trusts, could provide protection sufficiently long to accomplish medium range control objectives. If a longer period is desired then an alternative control device, such as a proxy coupled with an interest, must be utilized. For a discussion of the so-called irrevocable "proxy coupled with an interest," see O'NEAL, *supra* note 78, §§ 5-36, at 124-27.

99. *Id.* § 4-401(a)(5).

100. *Id.* § 2-413(a) states that "[u]nless the bylaws provide otherwise, the board of directors shall elect the officers" (emphasis added).

101. 2 FLETCHER, *supra* note 43, § 336 ("Contracts of employment for life or indefinite periods of officers and other key personnel are generally invalid because they bind the hands of future boards of directors"). For a general discussion of the contrary views supporting long term officer employment contracts, see HERWITZ, *supra* note 88, at 40, and note 102 *infra*.

The Maryland general corporation statute, however, would appear to validate long-term appointment or election of officers if approved by the board of directors.¹⁰² Thus, Title Four's authorization of long-term officer employment contracts without regard to the length of the term of the board of directors does not accomplish anything that cannot be implemented under the general corporation law.

While the general corporation law specifically empowers the board of directors to remove an officer, such removal cannot operate to prejudice his or her contract rights for damages.¹⁰³ It may be argued that the unanimous stockholders' agreement can authorize a more permanent employment agreement, but whether the agreement can guarantee employment and non-removal is questionable.¹⁰⁴ Such permanent employment seems contrary to the long-standing public policy against specific enforcement of employment agreements.¹⁰⁵ Hence, an employee of a close corporation, like an employee of any other corporation, probably can resort only to a damage remedy, and not to specific performance, under Title Four. Even if a forced employment relationship were possible, it could lead to such "internal dissension" as to trigger the Title Four dissolution provisions.¹⁰⁶

"The payment of dividends or division of profits" may be regulated by the statutory close corporation stockholders' agreement.¹⁰⁷ Such a permissible use of the stockholders' agreement may be viewed as circumventing the traditional general corporation law pre-requisite that the declaration of dividends is a matter within the discretion of the board of directors of the corporation.¹⁰⁸ However, this power of

102. CODE § 2-413(b). Herwitz is in accord, stating:

"[i]t is now clear that the board of directors has the power to execute an employment contract extending beyond its own term; and in the close corporation area it is likely that the duration of an employment contract, even one for the life of the employee, would not be a ground for invalidating it."

HERWITZ, *supra* note 88, at 39.

Although long-term employment contracts are valid it is clear that such contracts cannot operate to deny a subsequent board of directors its absolute statutory right to remove officers. CODE § 2-413(c). However, high or unanimous voting requirements could be imposed to provide protection against termination similar to that which may be provided by the unanimous stockholders' agreement. Imposition of such a high vote requirement would make the likelihood of removal remote.

103. CODE § 2-413(c) (2).

104. See HENN, *supra* note 49, § 289, at 572.

105. See *id.* § 221, at 434-36 nn.1-9 & § 278, at 547.

106. CODE §§ 4-602, 4-603. Dissolution is discussed at notes 51-56 and accompanying text *supra*.

107. *Id.* § 4-401(a) (7).

108. HENN, *supra* note 49, § 327, at 665. See CODE § 2-309(a).

the board may be modified and dividend and profit allocation may be regulated by the including in the articles of incorporation of a privately-held corporation stockholder agreements respecting dividend preferences.¹⁰⁹ Furthermore, provisions may be included for setting apart dividends for, or paying dividends to, the holders of specified classes of stock before any dividends are set apart for or paid to holders of other classes of stock.¹¹⁰ Articles of incorporation filed under the general law may even expressly dilute directors' discretion with respect to dividends to the extent of specifying the "rate, amount, and time of payment of the dividends."¹¹¹ Hence, it would seem that the degree of latitude which the general corporation law accords the privately-held corporation for regulating the division of profits and the payment of dividends is at least co-extensive with that which may be accorded to a statutory close corporation through the unanimous stockholders' agreement.¹¹²

109. CODE § 2-105(3) (iii).

110. *Id.* § 2-105. This section provides:

A Corporation may provide by its charter:

(3) (i) That the corporation shall set apart dividends for or pay dividends to the holders of a specified class of stock before any dividends are set apart for or paid to the holders of another class of stock;

(ii) The rate, amount, and time of payment of the dividends; and

(iii) Whether the dividends are cumulative, cumulative to a limited extent, or noncumulative.

The utilization of separate classes of stock may have the effect of denying to the corporation the right to elect Subchapter S status. *See* INT. REV. CODE OF 1954, § 1371(a) (4). *But see* Rev. Rule 73-611, 1973-2 C.B. 312 (suggests that designation of classes of voting and nonvoting stock by stockholders' agreement rather than by charter does not effect right to elect Subchapter S status). This loss, however, should not disadvantage the privately-held corporation vis-à-vis the Title Four corporation since the Internal Revenue Service should treat special Title Four corporation provisions respecting differences in payment of dividends and profits under the unanimous stockholders agreements as creating separate classes of stock, thereby defeating the right to elect Subchapter S status. *See* Treas. Reg. § 1.1371-1(g) (1968) which provides in pertinent part: "If the outstanding shares of stock of the corporation are not identical with respect to the rights and interest which they convey in the control, profits, and assets of the corporation, then the corporation is considered to have more than one class of stock. Thus a difference as to voting rights, dividend rights, or liquidation preferences of outstanding stock will disqualify a corporation" from being a "small business" eligible to elect Subchapter S status (emphasis added).

111. CODE § 2-105(3) (ii), quoted in full at note 110 *supra*.

112. It is significant to note that section 2-309(a) of the general corporation law provides that the declaration of a dividend by the board of directors may be made only if it is not "contrary to a restriction contained in its charter." *Id.* § 2-309(a). A fair inference from this provision is that imposing limitations upon the declaration of dividends, for example, by a unanimous director voting requirement, may also be accomplished through the charter of a privately-held corporation. It should also be noted that employment agreement incentive compensation provisions may be utilized to divide profits.

The foregoing demonstrates that substantially all of the matters that may be regulated by the unanimous stockholders' agreement of a statutory close corporation may be implemented equally effectively in the articles of incorporation, by-laws, and restrictive transfer or buy-sell agreements of a privately-held corporation. Moreover, the implementation of such provisions in the traditional general corporation documents would seem to be less burdensome for the corporate planner than utilizing the unanimous stockholders' agreement. Some counsel might nevertheless find the unanimous stockholders' agreement a useful device and its validity should therefore be upheld even outside the Title Four context. Unfortunately, the validity of such agreements prior to the enactment of Title Four was never reassuringly clear, and it is for this reason that their express validation by that statute was greeted with such acclaim.¹¹³ On balance, however, it seems likely that the courts will — and should — sustain the validity of such agreements in the context of privately-held corporations as well.

In particular, prior to the enactment of Title Four, the Maryland Court of Appeals, in *DeBoy v. Harris*,¹¹⁴ sustained the validity of an agreement by three individuals respecting their contemplated organization and operation of a corporation. Among other things the agreement designated the recipients of the stock to be issued and their percentages of stockholdings, fixed the corporation's capital structure, and specified profit sharing and officer salaries. The three stockholders apparently carried on their corporate affairs in compliance with the agreement for just over four years, at which point one stockholder brought suit for breach of the agreement by the other two. The aggrieved stockholder grounded his action on his ouster as an officer and director, a change in the corporation's capital structure, the issuance of additional stock, and the consequent reduction of his percentage of profits. The court recognized the issue of enforceability of the stockholders' agreement as one of first impression in Maryland. Citing a line of authorities from other jurisdictions favoring the enforceability of such agreements "if rights of third parties have not intervened,"¹¹⁵ the court analogized the agreement to one among joint venturers and held that it survived the incorporation of the business and was therefore valid.

113. Hall, *supra* note 7, at 344.

114. 207 Md. 212, 113 A.2d 903 (1955).

115. *Id.* at 219, 113 A.2d at 907.

The implications of the *DeBoy* holding for stockholders' agreements in privately-held corporations is not diminished by the unanimous stockholder agreement provisions of Title Four. The Maryland legislature has mandated that nothing in those provisions shall "affect any otherwise valid agreement among stockholders of a close corporation or of any other corporation."¹¹⁶ It would seem, therefore, that agreements patterned on the covenants sustained in *DeBoy* establish a minimum level of privately-held stockholder agreement validity. Furthermore, the broad statutory provisions for allowing corporate control under the Maryland general corporation law¹¹⁷ indicate a legislative sanction for parties to agree on certain control provisions upon incorporation. Whether such agreement is embodied in the traditional corporate document, as advocated in this article,¹¹⁸ or in a contract between the initial shareholders, the choice of form should have little effect on the legality of the agreement. The factor controlling validity should be whether the provisions lie within the boundaries of permissible allocation of control in any corporate context.¹¹⁹

The most obvious of these boundaries is the long-standing prohibition against invasion of the discretionary powers of the board of directors through stockholder agreements. Certain courts have repeatedly invalidated stockholders' agreements that attempt to dictate to the board management decisions traditionally within its discretion.¹²⁰ It is clear that a stockholders' agreement in a privately-held corporation would not be enforced if it completely preempted the discretion of the board of directors.¹²¹ Short of total preemption of the board's management function, however, it appears that the stockholders of a privately-held corporation in Maryland have broad latitude to guide management decisions. The two main areas of management traditionally left to the discretion of the board are the selection and tenure of corporate officers, and the declaration of dividends. In *DeBoy* the Maryland Court of Appeals upheld the validity of a shareholders' agreement which designated certain individuals as corporate officers

116. CODE § 4-401(e). See Hall, *supra* note 7, at 344 n.14.

117. See CODE §§ 2-104, 2-105.

118. Text following note 112 *supra*.

119. Stockholder agreements have been invalidated in some jurisdictions because they violated statutory norms for corporate management. See generally O'NEAL, *supra* note 78, § 5.06, at 18-27 and cases cited therein. Obviously, the broader the statutory norms are the greater the permissible scope of stockholder agreements will be. The breadth of the Maryland law is suggested at note 117 and accompanying text *supra* and in the text following this note.

120. See generally O'NEAL, *supra* note 78, § 5.16, at 53-62 and cases cited therein.

121. *Id.*

and provided for their tenure for an indefinite, but potentially lengthy period.¹²² Although the validity of a shareholders' agreement specifying dividend declarations has not yet been tested in Maryland, the Supreme Court of Illinois, in *Galler v. Galler*¹²³ upheld such an agreement in the context of a privately-held corporation, based on reasoning similar to that in *DeBoy*. Like the *DeBoy* court, the Illinois court noted that in the absence of fraud or injury to the public or to creditors, and absent violations of specific statutory provisions, there is no reason for denying enforcement of a stockholders' agreement.¹²⁴

Significantly, in *Galler*, the court reached its decision where the stockholders' agreement was not even unanimous. One stockholder, although voicing no opposition, was not an actual party to it. Hence, where an agreement is unanimous among the stockholders of a privately-held corporation, the reasons expressed in *Galler* for upholding it are even more valid, on estoppel-like grounds.¹²⁵ Moreover, in a privately-held corporation, the stockholders are usually both the directors and the officers, an interrelationship that, in fact, precludes preemption of management discretion from the board of directors since the individual parties to the agreement retain management powers as members of the board. The recognition accorded this dual role of stockholder and corporate manager by Title Four should be extended to a privately-held corporation characterized by an identity of interests between stockholders and directors. The reasons which justify the statutory sanctioning of an unanimous stockholders' agreement for the Title Four corporation are equally applicable, absent a clear holding to the contrary in Maryland, to the validation of such an agreement under the general corporation law.

Hence, participants in a privately-held corporation could solidify their understandings through a stockholders' agreement similar to the Title Four unanimous stockholders' agreement. Despite the existence of such an option under the general corporation law, however, utilization of the traditional corporate documentation would seem a preferable method for implementing agreements among participants in a privately-held enterprise.

122. See 207 Md. at 214-15, 113 A.2d at 905.

123. 32 Ill. 2d 16, 203 N.E.2d 577 (1964).

124. *Id.* at 24-26, 203 N.E.2d at 582-83. See also *Pohn v. Diversified Indus., Inc.*, 403 F. Supp. 413 (N.D. Ill. 1975).

125. See *Clark v. Dodge*, 269 N.Y. 410, 199 N.E. 641 (1936).

E. *Liberal Inspection Rights*

Title Four expands stockholder inspection rights beyond those prescribed by the general provisions.¹²⁶ Nevertheless, if a privately-held corporation is structured so that all stockholders are directors,¹²⁷ then such stockholders in their capacity as directors, will have the broadest possible rights to inspect corporate records.¹²⁸ Furthermore, if a non-director stockholder owns at least five percent of the corporation's outstanding stock, he will have a right of inspection almost as extensive as that of a stockholder of a statutory close corporation.¹²⁹

F. *The Reduction of Formalities*

Selection of Title Four status is advocated in part because of its much vaunted simplification and reduction of formalities.¹³⁰ It would be misleading to infer, however, that the general corporation law requires strict, burdensome, and unnecessary formalities. Such an assumption lacks foundation; the general corporation law permits a wide range of choices for satisfying formal requirements, most of which represent neither surplusage nor difficulty for the privately-held corporation.

The general corporation law provides that all corporations must hold annual stockholder meetings.¹³¹ Under Title Four annual meetings need only be held if requested by a stockholder.¹³² Yet general

126. CODE § 4-403 which provides:

A stockholder of a close corporation or his agent may inspect and copy during usual business hours any records or documents of the corporation relevant to its business and affairs, including any:

- (1) By-laws;
- (2) Minutes of the proceedings of the stockholders and directors;
- (3) Annual statement of affairs;
- (4) Stock ledger; and
- (5) Books of accounts.

See also Hall, *supra* note 7, at 360.

127. CODE § 2-104.

128. Although there is no specific statutory provision affording directors inspection without qualification, the right is well established. See, e.g., *In re Cohen v. Cocoline Products, Inc.*, 309 N.Y. 119, 127 N.E.2d 906 (1955); accord, 5 FLETCHER, *supra* note 43, § 2235, at 872 (perhaps the only qualifications would be improper motive or prevention of abuse).

This right is inherent in directors' fiduciary duties and the liability attached to directors for breach of these responsibilities. See also note 67 and accompanying text *supra*.

129. Compare CODE § 2-513(a) with *id.* § 4-403.

130. Hall, *supra* note 7, at 363.

131. CODE § 2-501(a).

132. *Id.* § 4-402(a).

corporation law annual meeting requirements are only directory: "The failure [of a privately-held corporation] to hold an annual meeting does not invalidate the corporation's existence or affect any otherwise valid corporate act."¹³³ Hence even a privately-held corporation need not hold annual meetings unless requested to do so by a stockholder on the threat of litigation or by judicial decree.

If counsel deems it prudent, and he or she should, for the stockholders to consider and record the types of matters designated for annual action,¹³⁴ such stockholders' action may be taken informally under the general corporation law. Directors may be elected and other stockholder actions implemented through unanimous written consent in lieu of an actual stockholder meeting.¹³⁵ In the event that there is such dissension within the corporation that these basic matters cannot be implemented informally, then a face-to-face meeting of stockholders would seem to be a necessary step towards the resolution of differences.¹³⁶

The general corporation law also permits directors to act informally. Any action which would be appropriate at a board meeting may be accomplished without a meeting by unanimous written consent of the directors.¹³⁷ Moreover, directors may conduct meetings, without being subject to unanimity requirements, by conference telephone or similar equipment, provided that all directors can hear each other at the same time.¹³⁸ Hence, director action is not subject to the

133. *Id.* § 2-501(d).

134. *Id.* § 2-501(a), which provides: "Each corporation shall hold an annual meeting of its stockholders to elect directors and transact any other business within its powers." See also *id.* § 2-501(c).

135. *Id.* § 2-505 which provides:

Any action required or permitted to be taken at a meeting of stockholders may be taken without a meeting if the following are filed with the records of stockholders' meetings:

(1) A unanimous written consent which sets forth the action and is signed by each stockholder entitled to vote on the matter; and

(2) A written waiver of any right to dissent signed by each stockholder entitled to notice of the meeting but not entitled to vote at it.

136. This would apply equally to Title Four corporations wracked by dissension and a stockholder could require that such a meeting be held. CODE § 4-402(a).

137. *Id.* § 2-408(c), which provides:

Any action required or permitted to be taken at a meeting of the board of directors or of a committee of the board may be taken without a meeting, if a unanimous written consent which sets forth the action is:

(1) Signed by each member of the board or committee; and

(2) Filed with the minutes of proceedings of the board or committee.

138. *Id.* § 2-409(d), which provides:

(1) Unless restricted by the charter or bylaws of the corporation, members of the board of directors or a committee of the board may participate

formalistic and sometimes inconvenient constraints of the traditional mode of a formal meeting.¹³⁹

III. A NEEDED LEGISLATIVE CHANGE: PROVIDING FOR LESS THAN THREE DIRECTORS

In the foregoing sections of this article, an attempt has been made not only to demonstrate the dangers inherent in statutory close corporation status, but also to demonstrate that almost all of its purported advantages are available under the general corporation law. There is, however, one important area in which the general corporation law fails to offer what is available under Title Four. The former requires that a corporation have at least three directors.¹⁴⁰ Complying

in a meeting by means of a conference telephone or similar communications equipment if all persons participating in the meeting can hear each other at the same time.

(2) Participation in a meeting by these means constitutes presence in person at the meeting.

139. It could be argued that a corporation comprised of only one or two stockholders may be unnecessarily encumbered by the three-person board required for a general corporation. A partial rebuttal to such a contention is that a three-person board could act through a quorum of two directors. CODE § 2-408(b)(2)(ii). Nevertheless, it would seem more logical to permit a corporation of less than three stockholders an exemption from the traditional three-board member requirement rather than commit it to Title Four status with its attendant disadvantages. Legislation to effect this result in Maryland is recommended in Section III of this article *infra*, *A Needed Legislative Change: Providing For Less Than Three Directors*. See also Hall, *supra* note 7, at 358.

140. CODE § 2-402(a). Neither the origins of, nor the reasons for, the three-person board of directors are clear. The argument has been made that when one person is a stockholder and also fills all offices, "he may do some action in the wrong capacity or may so ignore the corporate formalities that it becomes more likely that a court will 'pierce the veil' and ignore the formal corporate existence. Another danger is that if the one man director-officer-stockholder becomes ill or incapacitated, corporate activities may be hamstrung." Hayes, *Directors and Officers in the Iowa Corporation — Conclusion (Part V of A Study of Iowa Incorporation Practices)*, 40 IOWA L. REV. 587, 588-89 (1955). Of course corporate documents could provide for the contingency of illness or incapacity of the so-called one-person director-officer-stockholder. Furthermore, it is not clear how straw directors would necessarily be in a position to undo the hamstring imposed upon a corporation's activity by the incapacity of its sole management person.

The concept of three director requirements has been explained in another fashion:

"It is said that the Roman equivalent of the corporation required three incorporators. The potency of the magic number has survived into our day Immemorially, the American corporation has been required to have three directors"

Spoerri, *One Incorporator, One Director*, 19 BUS. LAW. 305, 307 (1963).

In the end, however, the reason for the three-person board requirement may just be that the draftspersons of the original corporation statutes simply did not contemplate one-person corporate entities.

with this requirement frequently leads to the artificiality of electing "dummy" or "straw" directors to fill a privately-held corporation board. Moreover, such directors, frequently spouses or compliant friends, do not benefit the corporation by deliberate management involvement, but serve only in a nominal and passive capacity.

To avoid confronting stockholders in a one- or two-person privately-held enterprise with the choice of either electing such "silent" directors under general corporation law or operating under statutes such as Title Four, a minor modification of Maryland's general law would seem to be in order. Provision must be made, as has been done in thirty-nine jurisdictions, for reduced numerical board of director requirements.¹⁴¹

Modification of Maryland's general corporation law standard that "[e]ach corporation shall have at least three directors at all times"¹⁴² could be implemented with relative ease. It is suggested that the statute, section 2-402, be amended to provide as follows:

(a) *Minimum Number.* The number of directors constituting the entire board of directors shall not be less than three, except that (i) before there is stock outstanding, the number of directors constituting the entire board of directors may be less than three, but not less than one, and (ii) where there is stock outstanding and all shares of stock of a corporation are owned beneficially and of record by less than three stockholders, the number of directors constituting the entire board of directors may be less than three, but not less than the number of such stockholders. At any time that a corporation shall no longer be entitled to have less than three directors, as provided in this subsection, its by-laws or charter, as hereinafter provided, shall set forth the number of directors which shall constitute the entire board of directors of such corporation.

Obviously, such a minimal statutory modification would permit a privately-held corporation with a sole stockholder to have one director and a two-stockholder entity to have a board consisting of two members.

141. Those states which require no directors, or a minimum of one, or which allow two directors in a two-stockholder corporation and one director in a one-person corporation include Arizona, Arkansas, California, Connecticut, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa (fixed by by-laws), Kansas, Kentucky, Louisiana, Maine, Massachusetts, Michigan, Minnesota, Missouri, Nebraska (fixed by by-laws), Nevada, New Hampshire (fixed by by-laws), New Mexico, New York, North Carolina, Ohio, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Virginia, Washington, West Virginia, Wisconsin, and Wyoming. It is significant to note that in 1975 alone, three of the above states changed from requiring at least three directors to allowing fewer.

142. CODE § 2-402(a).

IV. CONCLUSION

Legislative action such as that set forth in the preceding section would modernize Maryland's general corporation law and bring it into line with the great majority of states. More significantly, counsel planning an enterprise of two or fewer stockholders would not be forced to choose the treacherous path of deadlock statutes like Title Four in order to avoid designation of the illusory straw board member. Corporate planning will thus be put back into its proper perspective — accounting for the vicissitudes of human nature through the "infinite variations"¹⁴³ permissible under the general corporation law.

143. HENN, *supra* note 49, § 1, at 2.

AUTHOR'S NOTE

Prior to publication of this article, copies of the galleys were circulated to the members of the Corporations, Banking and Business Section Council of the Maryland State Bar Association. Following review of the legislation proposed in this article, the Council recommended legislation similar in result but broader in scope. The main distinction between the legislation proposed herein and that proposed by the Council is that the Council's proposal allows a minimum of one director, regardless of the number of stockholders. The Council's proposed bill for submission to the Maryland Legislature on a prefiled basis would amend section 2-402 to read as follows:

2-402. Number of directors.

(a) Number. — Each corporation shall have one or more directors at all times.

(b) Charter provision. — A Maryland corporation shall have the number of directors provided in its charter until changed by the bylaws.

(c) Bylaws provision. — The bylaws may:

*(i) Alter the number of directors set by the charter;
and*

(ii) Authorize a majority of the entire board of directors to alter within specified limits the number of directors set by the charter or the bylaws, but the action may not affect the tenure of office or any director.